No. 12756

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CLARK SQUIRE, Collector of Internal Revenue,

Appellant

vs.

STUDENTS BOOK CORPORATION,

Appellee

UPON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

BRIEF FOR THE APPELLANT

HONORABLE CHARLES H. LEAVY, *Judge*

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Assistant Attorney General.

ELLIS N. SLACK,

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OPINION BELOW

The findings of fact and conclusions of law of the District Court (R. 23-30) and its oral opinion (R. 76-81) are unreported.

JURISDICTION

This appeal involves federal income taxes. The taxes in dispute were paid on various dates between

March 15, 1944, and December 15, 1948. (R. 28.) The taxpayer filed claims for refund on March 13, 1947, for all federal taxes paid for the years 1943 through 1945, and these were rejected by notice dated September 27, 1948. (R. 29.) The claims for 1946 and 1947, dated June, 1948, have not been acted upon. (R. 29.) Within the time provided in Section 3772 of the Internal Revenue Code and on April 7, 1949 (R. 7), the taxpayer brought an action in the United States District Court for the Western District of Washington for recovery of taxes paid. (R. 3-7.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1340. The judgment was entered on July 12, 1950. (R. 31-32.) Notice of appeal was filed August 31, 1950 (R. 32-33), pursuant to the provisions of 28 U.S.C., Section 1291.

QUESTION PRESENTED

Whether a conventional business corporation, engaging in the operation of a competitive business for profit (book store and restaurant), is exempt from federal income tax under Section 101(6) and (14) of the Internal Revenue Code as being "organized and operated exclusively for an educational purpose.

STATUTE AND REGULATIONS INVOLVED

These are set forth in the Appendix, *infra.*

STATEMENT

The facts as found by the District Court (R. 24-29) and as stipulated by the parties (R. 11-23) may be summarized as follows:

Taxpayer, a Washington corporation, succeeded in 1923 to the Student Book Incorporated, a corporation organized in 1914 by the Associated Students of the State College of Washington, hereinafter referred to as the A.S.S.C.W., which supplied the original capital in the sum of $2,000. (R. 11-12, 24-25.)

The taxpayer corporation for many years has operated a store on its own property adjoining the campus of the State College of Washington for the sale to students and faculty members at reasonable prices of textbooks, students' supplies and other items for the accommodation of students and faculty members. The management of the Students Book Corporation at all times works in coordination with the administration and faculty of the State College in determining items of textbooks and students' supplies to be carried in stock. In addition to its main store, taxpayer also has conducted a student restaurant on the campus of the State College in quarters furnished to taxpayer without charge by the college in a building designated the old gymnasium. Approximately

four per cent of taxpayer's business is done with persons not connected with the college. (R. 26.)

At all times since taxpayer's organization and until March 1, 1947, all of its stock was owned by A.S.S.C.W., a non-profit corporation organized under the laws of Washington and at all times subsequent to March 1, 1947, all of taxpayer's stock was held by the Board of Regents of the State College of Washington pursuant to a trust agreement between the Board of Regents and the A.S.S.C.W., whereby the principal and net earnings of the trust shall be used only in furtherance of the purposes for which the A.S.S.C.W. is organized. (R. 24-25.)

Dividends paid by taxpayer corporation were, from the time of its organization until March 30, 1929, paid to A.S.S.C.W. in the form of stock dividends, thereafter dividends were paid in cash to the A.S.S.C.W. Dividends paid in 1933 and 1934 were earmarked in the resolution by which they were declared for specific purposes; first, to finance a publication of the A.S.S.C.W. for distribution to students, and second, to finance the painting of President Emeritus E. A. Bryan, which was presented to the State College of Washington. With these exceptions the Board of Trustees of Students Book Corporation followed the dividend policy to make available funds

for the building of a student union building adjacent to or on the present campus of the State College of Washington. The Board of Trustees declared dividends at such times as the A.S.S.C.W. asked for money to implement the program for the construction of a student union building, which dividends were transferred to the bursar (now comptroller) of the State College, who in turn has disbursed these funds for the purchase of lands, title to which is held in the name of the State of Washington, and for other purposes connected with the construction of the student union building. Funds in excess of those needs are held in marketable securities. (R. 26-27.)

Taxpayer corporation has never passed a rebate to the students, faculty members or customers. The proposed student union building, when constructed, will be the property of the State of Washington. (R. 27.)

The taxpayer's charter authorized it to carry on a general book, stationery, sporting goods, refreshment and general mercantile business, to buy and sell real estate, and to engage in a general insurance business. (Ex. 1, R. 82-83.)

For the taxable years 1943 through 1947 the taxpayer paid to the Collector of Internal Revenue (appellant herein) corporate income, capital stock

and excess profits taxes aggregating $71,933.15. (R. 28.)

The taxpayer filed claims for refund for all federal taxes paid for the taxable years 1943 through 1947. The claims for 1943 to 1945 were formally rejected. Those for 1946 and 1947 had not been acted upon when this proceeding was commenced but more than six months from the time of filing of the claims had expired. (R. 29.)

The taxpayer brought suit for refund, and, in rendering judgment for the taxpayer (R. 31-32), the District Court held that it was exempt under Section 101(6) of the Internal Revenue Code as the "alter ego" of the A.S.S.C.W. (R. 29, 79). The present appeal followed.

STATEMENT OF POINT TO BE URGED

The District Court erred in holding that the taxpayer (book store and restaurant) is organized and operated exclusively for educational purposes within the meaning of Section 101(6) of the Internal Revenue Code.

SUMMARY OF ARGUMENT

The District Court erroneously held that taxpayer, a corporation engaged exclusively in the busi-

ness of running a book store and operating a restaurant in competition with like commercial enterprises, is exempt from federal taxation. Its decision is clearly in conflict with the controlling statutory provisions, their legislative history, and long-standing Treasury Regulations and the applicable decisions.

In the first place, taxpayer is disqualified for exemption because its expressed purpose in the corporate charter and its activities do not reflect an educational purpose. Selling books, real estate and insurance — purposes set forth in the corporate charter — are certainly not directed toward an educational, exempting end. The activities of the taxpayer, involving the operating of a book store and restaurant, similarly do not look in the direction of an educational purpose. The fact that students and faculty were accommodated does not alter this conclusion. Neither does the fact that faculty members assisted in the control of taxpayer change the result, since they did so in an individual and not an official capacity. Any supervision by the college was based on a profit-wise association rather than on any legal rights to that supervision by the college authorities under the corporate charter and by-laws.

Code Section 101(6) exempts from tax a corporation which (1) is "organized and operated exclu-

sively for religious, charitable, scientific, literary, or educational purposes;" and (2) "no part of the net earnings of which inures to the benefit of any private shareholder or individual." Compliance with the second condition, as in the instant case, does not dispense with compliance with the first. The corporation, as distinguished from its shareholders, must be "organized and operated exclusively" for the specified purposes.

To hold that a conventional business corporation is itself exempt from tax because its stockholders are exempt would telescope into one the separate requirements of Section 101(6). It would fuse the separate taxable entities of a corporation and its stockholders (or stockholder) by ascribing to a corporation whose operations are purely commercial the educational functions of its stockholders. It would render superfluous the requirements of Section 101(14), which must be read in conjunction with Section 101(6). And it would attribute to Congress an intention to discriminate among competing business enterprises by granting tax immunity to those whose stockholders happen to be tax exempt. That this was the mistake of the District Court is emphasized by its erroneous finding that the taxpayer and the A.S.S.C.W. should be equated for tax purposes.

The applicable decisions of the Supreme Court and other courts likewise confirm the incorrectness of the decision below.

Nor is there anything in the legislative history of Section 101 which supports the trial court's interpretation of the statute. On the contrary, it is abundantly clear from the history and provisions of the Revenue Bill of 1950 and the accompanying committee reports, that Congress never intended to sanction the exemption of business corporations simply because their income is destined for exempt organizations.

ARGUMENT

THE DISTRICT COURT ERRED IN HOLDING THAT THE TAXPAYER IS A CORPORATION ORGANIZED AND OPERATED EXCLUSIVELY FOR EDUCATIONAL PURPOSES WITHIN THE MEANING OF SECTION 101(6) OF THE INTERNAL REVENUE CODE. IT IS A CORPORATION ORGANIZED AND OPERATED FOR THE PURPOSE OF CARRYING ON A GENERAL MERCANTILE BUSINESS (BOOKSTORE AND RESTAURANT) AND AS SUCH IS NOT EXEMPT FROM TAXATION.

Presented on this review is a single question, arising, for the most part, from a stipulated set of facts: whether a conventional business corporation carrying on ordinary activities for profit in compe-

tition, or possible competition, with similar business enterprises is entitled to federal income tax exemption under Section 101(6) of the Internal Revenue Code, Appendix, *infra*.

The answer to the problem involved herein turns upon certain factual considerations and upon the legislative intent expressed in Code Section 101(6) and corollary Section 101(14), Appendix, *infra*.[1] The District Court held (R. 29-30, 79) that the taxpayer is immune from tax. We submit that its decision is not in accord with the controlling statutory provisions, their legislative history, the long-standing Treasury Regulations and rulings, and the applicable decisions of the Supreme Court and other courts.

A. *Taxpayer is disqualified for exemption because its expressed purpose and its activities do not reflect an educational purpose.*

The taxpayer's charter authorized it to carry on a general book, stationery, sporting goods, refreshment and general mercantile business, to buy and sell real estate, and to engage in a general insurance busi-

[1] Any claim for exemption under Section 116(d) of the Internal Revenue Code, Appendix, *infra*, is similarly without merit. Taxpayer's income was not derived from any public utility or the exercise of any governmental function and accruing to any state, etc. See *Bear Gulch Water Co. v. Commissioner*, 116 F. (2d) 975 (C.A. 9th), certiorari denied, 314 U. S. 652; *Ohio v. Helvering*, 292 U. S. 360.

ness. (Ex. 1, R. 82-83; Ex. 2, R. 84.) During the taxable years, it operated a store on its own property adjoining the campus of the State College of Washington, in which it sold, mostly at retail prices, textbooks, students' supplies, candies, confections, guest supplies, and other items. (R. 18, 26.) Taxpayer also operated a restaurant which was located on its property until 1946, at which time the restaurant was moved to larger quarters on the campus furnished without charge by the college. (R. 26, 52.) The store and restaurant were open to the general public at the same prices, and taxpayer was in competition with other stores and restaurants. (R. 65.)

The State College of Washington did not own any interest in the taxpayer book store and restaurant, was not responsible for its debts and not entitled to any part of its earnings during the taxable periods involved herein. (R. 20.) All of taxpayer's stock was owned by the A.S.S.C.W., and the stockholders were appointed by the president of A.S.S.C.W., two of whom were members of the faculty of the college. (R. 24, 85-86.) The governing board of the taxpayer was composed of nine trustees who were elected by the stockholders. (R. 86.)

It is clear from the foregoing that the taxpayer is not entitled to the claimed exemption because its

expressed purpose and activities do not bring it within the statutory provision, i.e., that it be organized and operated exclusively for educational purposes. The declaration of purposes contained in taxpayer's charter of incorporation is clear and explicit and correctly reflects the nature of the activities which taxpayer carries on. The selling of books, real estate and insurance are not purposes which are directed to the end of the "improvement or development of the capabilities of the individual," which Treasury Regulations 111, Section 29.101(6)-1,[2] Appendix, *infra*, correctly states to be the object of education, but, rather, promote the successful function of the business system on a profitable basis. In fact, there is no provision whatever with respect to educational purposes. Whether or not a corporation is organized exclusively for charitable purposes so as to come within the exemption granted by Section 101(6) is determined, in part, by its charter. *Sun-Herald Corp. v. Duggan*, 73 F. (2d) 298 (C. A. 2d), certiorari denied, 294 U. S. 719; *Stanford University Book Store v. Helvering*, 83 F. (2d) 710 (C.A. D.C.); *Gagne v. Hanover Water Works Co.*, 92 F. (2d) 659 (C. A. 1st). As was pointed out

[2] Section 29.101(6)-1 of Treasury Regulations 111, under the Code is derived from, and insofar as material here, is the same as Article 517 of Treasury Regulations 65, promulgated under the Revenue Act of 1924.

(p. 300) in the *Sun-Herald* case, in holding that a corporation which had sold its newspaper business and was still not capable, because of its charter, of taking advantage of the exemption provided in Section 101(14) of the Code:

> Such a corporation is not exempt from income taxes, for it was not organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the same to an organization which is exempt from the tax. Indeed, there is legally nothing to prevent it from re-engaging in a newspaper publishing business as authorized by its charter.

And as further stated in the *Hanover Water Works* case (p. 661) in looking to the purpose as expressed in the charter:

> It surely was not organized for the exclusive purpose of holding title to property and in fact did not limit its activities to such purposes.

Far from negativing the stated purpose of the taxpayer as an organization, the activities which taxpayer carried on clearly serve the same end. The facts that the book store catered primarily to students and faculty (R. 18) and that it was judicious profit-wise to accept the supervision of the college, as did the book store in the *Stanford* case, *supra*, do not outweigh the object toward which the activities were directed — an ordinary commercial enterprise. The taxpayer's activities, as already outlined, con-

sisted of operating an ordinary mercantile business and running a restaurant. It cannot be seriously contended that, in the circumstances of this case, these are educational purposes. Even if it be assumed, *arguendo*, that the only purpose of taxpayer was (R. 26) "the accommodation of students and faculty members," this does not mean that others than students and faculty were not similarly accommodated. In fact, in the *Stanford* case, *supra* p. 711, this was the express purpose of the store, and yet it was held that this was not an educational purpose.

The theory of exemption for educational and charitable purposes has been stated to be in *Dwight School, &c. v. State Board of Tax Appeals*, 114 N.J.L. 594, 600:

> Exemption can be justly sustained only on the principle that "the concession is due as a *quid pro quo* for the performance of a service essentially public, and which the state is relieved *pro tanto* from the necessity of performing, * * *

Certainly, measured by this view, it clearly cannot be said that the taxpayer corporation was rendering a service essentially public.

Hence, on the basis of the expressed purpose and the activities of the taxpayer it was not organized and operated exclusively for educational purposes within the meaning of the statute.

B. *Taxpayer corporation is not exempt from federal income tax merely because its stockholder is organized and operated exclusively for educational purposes and is therefore exempt.*

1. Code Section 101(6) exempts from federal income tax a corporation which (1) is "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes;" and (2) "no part of the net earnings of which inures to the benefit of any private shareholder or individual."[3] The long-standing implementing Treasury Regulations (Section 29.101(6)-1 of Regulations 111) make it clear that these requirements constitute *separate* conditions precedent to exemption. They provide, among other things, that:

> In order to be exempt under Section 101(6) the organization must meet three tests:
>
> (1) It must be organized and operated exclusively for one or more of the specified purposes;
>
> (2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and
>
> * * *

[3] A third statutory condition precedent to exemption, which taxpayer concededly satisfied and is not here involved, is that "no substantial part of * * * [its] activities * * * is carrying on propaganda, or otherwise attempting, to influence legislation."

Since taxpayer's net earnings inure to the benefits of a stockholder which is a tax exempt organization (R. 24-25), it unquestionably meets the second condition. But compliance with the second condition does not dispense with the necessity for compliance with the first. The corporation, as distintinguished from its stockholders, must be "organized and operated" for the specified statutory purposes. A conventional business corporation organized to operate and actually operating a competitive commercial enterprise for profit does not qualify for tax exemption merely because its profits inure to the benefit of a tax exempt stockholder. To hold that a business corporation is itself exempt from tax because its stockholders are exempt would telescope into one the separate requirements of Section 101(6) that no part of the corporation's net income inure to a private shareholder, *and* that the corporation be organized and operated exclusively for the purposes specified in the statute.

The statute is concerned with where the money comes from (activity) rather than where it goes. To hold otherwise, as did the lower court,[4] would be to

[4] That this was the basic mistake of the lower court seems clear from its finding of fact which, in effect, ignored the corporate structure of the taxpayer and equated for tax purposes the taxpayer, A.S.S.C.W., and the State College of Washington. (R. 29.)

erase from the statute the explicit requirement that the corporation be "operated" exclusively for "educational" or like purposes. Indeed, under the District Court's interpretation, even a corporation whose profits are derived from illegal business activities (e.g., gambling, narcotics) would be exempt from tax as a "religious" or "charitable" or "educational" organization if its stockholders happen to be religious or charitable or educational institutions. It is inconceivable that Congress so intended, and nothing in Section 101(6) lends any support to such view. See *C. F. Mueller Co. v. Commissioner*, 14 T. C. 922 (now on taxpayer's petition for review to the United States Court of Appeals for the Third Circuit).

2. In subdivision (14) of Section 101[5] Congress addressed itself to situations in which a corporation, which does not qualify for exemption under subdivision (6) or one of the other subdivisions of that section, dedicates its income to another organization which does qualify. It exempts from tax:

> Corporations organized for the exclusive purposes of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this chapter;

[5] Code Section 101(14) is derived from and is substantially the same as Section 11(a) Twelfth of the Revenue Act of 1916, c. 463, 39 Stat. 756.

Thus Congress was fully aware of the possibility that the earnings of a corporation which did not itself meet the exemption tests might be distributable to a tax exempt parent corporation, such as a university, a student organization, a labor union, a social club, etc. Yet it saw fit to limit the exemption in such cases to situations where the subsidiary corporation's only function is that of "holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses," to the exempt parent. When subdivision (14) is read together with the other subdivisions of Section 101, as it must be *(Helvering v. Stockholms &c. Bank*, 293 U. S. 84, 93-94; *United States v. Amer. Trucking Ass'ns*, 310 U. S. 534, 543-544), it is manifest that Congress intended to accord tax exempt status to a corporation on the basis of its own purposes and activities, not those of its parent-stockholder, except in one type of situation, namely, where the subsidiary serves merely as a holding and collecting agency for an exempt parent.

Had Congress intended to exempt any corporation—regardless of the nature of its activities—solely by virtue of the fact that its earnings are distributable to a tax exempt parent, it could readily and simply have said so. Instead, in subdivision (14) it

carefully circumscribed the subsidiary's right to exemption by providing that its activities must be confined to holding title to property. If, for example, taxpayer's stockholder were a labor organization which is exempt under subdivision (1) of Section 101 (rather than a student organization exempt under subdivision (6)), it certainly could not be maintained that taxpayer (a student book store and restaurant) is a labor organization merely because its stockholder is one. That its stockholder is tax exempt does not of course satisfy one of the several conditions precedent to exemption contained in subdivision (14). But the additional requirements of that subdivision must also be satisfied. *Bear Gulch Water Co. v. Commissioner*, 116 F. (2d) 975 (C. A. 9th), certiorari denied, 314 U. S. 652.

Unless the requirements of subdivision (14) are to be discarded as sheer surplusage, the conclusion is irresistible that ordinary business corporations like taxpayer are not entitled to exemption under subdivision (6) merely because their earnings inure to the benefit of an exempt parent corporation. As Judge Learned Hand stated in his dissenting opinion in *Roche's Beach, Inc. v. Commissioner*, 96 F. (2d) 776 (C. A. 2d):

> It is possible that, if subdivision 14 had not been added to Section 103, 26 U.S.C.A. § 103

(14) and note, we ought to have read subdivision (6), 26 U.S.C.A. § 103(6) note, to comprise companies all of whose profits go to one of the purposes therein described, although *Trinidad v. Sagrada Orden*, 263 U. S. 578, 44 S. Ct. 204, 68 L. Ed., 458, gives no color to such an interpretation; rather the reverse, for the business income of the taxpayer was there very trifling. It might nevertheless have been possible to say that as subdivision 6 defined exemption by function, and the other subdivisions by the common names of the corporations, a difference of intent was manifest, though I should not have thought so, because the description by function related, I think, to the corporate activities. But subdivision 14 precludes any such reading. Obviously, as to all other subdivisions it meant that a subsidiary should not be exempted merely because its parent was exempt; that was indeed one condition, but the subsidiary must also confine its activities to the mere receipt of income. We are now holding that the subsidiary of a company exempt under subdivision 6 need not fulfill this second condition, but is *ex proprio vigore* as much within subdivision 6 as its parent. It might be desirable to prefer corporations within subdivision 6 in that way, but I cannot find any warrant for doing so. The purpose of subdivision 14 was to tax all business income, however destined, unless the company was really not in business at all. To some extent it is indeed true that that purpose can be evaded; an exempt corporation may go into business not strictly germain to its charter powers without losing its exemption. But there are several checks upon this possibility; first, the business must be small, if the corporation is to retain its classification under its appropriate subdivision; second, in many cases it will wince at exposing its funds to the hazards of business; third, its

> charter will often forbid such excursions. But I believe that when, however actuated, an exempt parent does resort to a business subsidiary, any income so obtained becomes taxable. For these reasons I think that the Board was right.

Significantly, no claim is (R. 38) or can be made here that taxpayer qualifies for exemption under Section 101(14).

That Congress did not intend to exempt a business corporation from tax merely because its net income is distributable to a tax exempt organization is also confirmed by Code Section 23(q)(2), which limits allowable deductions by a corporation on account of contributions to organizations described in Section 101(6) to an amount not exceeding 5 per cent of its net income. This section too would become meaningless if, as taxpayer argues, the entire net income of a business corporation escapes tax merely because the income is destined for a tax exempt organization.

3. It is axiomatic that a corporation and its stockholders are separate and distinct taxable entities. *Moline Properties v. Commissioner*, 319 U. S. 436; *National Carbide Corp. v. Commissioner*, 336 U. S. 422; *Burnet v. Commonwealth Imp. Co.*, 287 U. S. 415. To hold that a purely commercial corporation in competition with others is exempt from tax

on its net income because its stockholders are exempt from tax on their net income does violence to the basic principle. Had taxpayer's stockholder itself conducted taxpayer's book store and restaurant, it would not have been entitled to tax exemption even though it also carried on educational activities. Such activities would "amount to engaging in trade" and consist of "selling to the public in competition with others." *Trinidad v. Sagrada Orden*, 263 U. S. 578, 582. See also *Better Business Bureau v. United States*, 326 U. S. 279; *Underwriters' Laboratories v. Commissioner*, 135 F. (2d) 371 (C. A. 7th), certiorari denied, 320 U. S. 756; Sec. 29.101(6)-1 of Treasury Regulations 111.[6] It follows then clearly that taxpayer corporation which performed no educational functions is not exempt. *Bear Gulch Water Co. v. Commissioner*, 116 F (2d) 975 (C. A. 9th), certiorari denied, 314 U. S. 652; *Gagne v. Hanover Water Works Co.*, 92 F. (2d) 659 (C. A. 1st).

Any other construction of Section 101 (6) than that urged by the Collector ascribes the purposes and functions of a corporation's stockholder to the corporation itself and, as a consequence, treats a con-

[6] Section 29.101(6)-1 of Treasury Regulation 111 provides that a corporation which has exempt purposes and "which also manufactures and sells articles to the public for profit" is not exempt.

ventional business corporation as though it were an educational institution. It is one thing to exempt from tax dividends received by a tax exempt institution from a business corporation. It is quite another thing to exempt the corporation's profits from tax. The tax status of the stockholder is no more determinative *per se* of that of the corporation than, conversely, the tax status of the corporation is determinative of that of the stockholder. They are separate entities for tax no less than for other purposes.

At this juncture, it should be noted that the lower court's finding (R. 29, 79) that the taxpayer was the *alter ego* of the A.S.S.C.W. doubly emphasizes the fact it was making this fundamental mistake. Its finding in this connection is "clearly erroneous." See *United States v. Gypsum Co.*, 333 U. S. 364, 394, rehearing denied, 333 U. S. 869. Taxpayer was no more the *alter ego* of its stockholder than any corporation is the *alter ego* of its stockholder or stockholders in the sense that they can dictate the policies and activities of the organization within the framework of the charter powers and purposes. But taxpayer had a separate corporate existence which should not be ignored. This same theory of equating a book store and an exempt institution which it served was advanced in *Stanford University Book*

Store v. Helvering, supra, and rejected by the court (p. 712):

> It must be remembered that the association is not, in contemplation of law, a division or part of the university. The university as such does not own any interest in the association, is not responsible for its debts, is not entitled to any part of its earnings, and takes no part in conducting and managing its affairs. The two institutions are separate legal entities and therefore the attributes of the university cannot be attributed to the association, nor can the latter claim to be an educational institution because the university is such. The members of the faculty of the university, as such, were not charged with the duty of conducting the affairs of the association.

Thus, the book store in the instant proceeding, as in the *Stanford* case, was not an integral part of the exempt organization which it served. In the *Stanford* case, the members of the university faculty were the officers and directors of the book store, but they were employed in an individual and not a collegiate capacity. In this case, it is also clear that any faculty member who served, did so in an individual and not a representative capacity. Similarly, cooperation with the faculty on the part of the taxpayer in the stocking of adopted books (R. 19), or in the stockholder-corporate relationship with A.S.S.C.W., does not make the taxpayer a division or part of the college or the *alter ego* of A.S.S.C.W.

4. The construction which the District Court puts upon Section 101 (6) (equating a corporation with its tax exempt stockholder) results in harsh discrimination between corporations engaged in profit-seeking business activities whose stockholders are tax exempt and those engaged in similar activities but whose stockholders are not exempt. It affords the former a tremendous competitive advantage over the latter, since businesses whose profits are tax exempt are obviously in a position to undersell those whose profits are subject to diminution by the tax. "A desire for equality among taxpayers is to be attributed to Congress, rather than the reverse." *Colgate Co. v. United States*, 320 U. S. 422, 425.

Nothing in Section 101 or elsewhere warrants the assumption that Congress meant to grant tax immunity to a corporation engaged in ordinary commercial activity for profit — and thereby foster economic inequality among competing business enterprises — solely because the net income of its stockholder is exempt from tax. Nor is there any basis for imputing to Congress a desire to increase the tax burden of other taxpayers, by exonerating ordinary business corporations from tax on their profits, merely because their stockholders are granted exemption from tax on dividends received from the corporation. Quite apart from the explicit requirement in

Section 101 (6) that the corporation be operated exclusively for religious and charitable purposes, it is clear from corollary Section 101 (14) that Congress intended to exempt a corporation on the basis of its stockholders' right to exemption only where the corporation's activities are confined to "holding title" to income producing property.

5. The decision below is in conflict not only with the controlling statutory provisions and the implementing Treasury Regulations but with the applicable decisions of the Supreme Court and other courts. *Better Business Bureau v. United States*, 326 U. S. 279; *Trinidad v. Sagrada Orden*, 263 U. S. 578, 582; *Universal Oil Products Co. v. Campbell*, 181 F. (2d) 451 (C. A. 7th), certiorari denied, 340 U. S. 850, rehearing denied, 340 U. S. 894; *Bear Gulch Water Co. v. Commissioner*, 116 F. (2d) 975 (C. A. 9th), certiorari denied, 314 U. S. 652; *Underwriters' Laboratories v. Commissioner*, 135 F. (2d) 371 (C. A. 7th), certiorari denied, 320 U. S. 756; cf. *Allen v. Regents*, 304 U. S. 439; *Davenport Foundation v. Commissioner*, 170 F. (2d) 70 (C. A. 9th); *Smyth v. California State Automobile Ass'n*, 175 F. (2d) 752 (C. A. 9th), certiorari denied, 338 U. S. 905.

In the *Better Business Bureau* case, *supra*, a corporation claimed exemption from social security

tax as an "educational" organization, under a section of the Social Security Act which contains the same language as Code Section 101 (6) here involved.[7] It was stipulated there that no part of the earnings inured to any private shareholder. In holding that the corporation was not entitled to exemption, the Court stated (p. 283):

> It has been urged that a liberal construction should be applied to this exemption from taxation under the Social Security Act in favor of religious, charitable and educational institutions. Cf. *Trinidad v. Sagrada Orden*, 263 U. S. 578; *Helvering v. Bliss*, 293 U. S. 144. But it is unnecessary to decide that issue here. Cf. *Hassett v. Associated Hospital Service Corp.*, 125 F. (2d) 611 (C. C. A. 1). Even the most liberal of constructions does not mean that statutory words and phrases are to be given unusual or tortured meanings unjustified by legislative intent or that express limitations on such an exemption are to be ignored. Petitioner's contention, however, demands precisely that type of statutory treatment. Hence it cannot prevail.

In denying the exemption to the book store connected with Stanford University, the Court *(Stanford*

[7] While the Supreme Court was there dealing with exemption from Social Security tax, its decision is highly persuasive here. The Court pointed out (p. 284) that the provision of the Social Security Act under construction "was drawn almost verbatim from Section 101 (6) of the Internal Revenue Code." It also relied upon the Treasury Regulations addressed to Code Section 101 (6).

University Book Store v. Helvering, supra) stated (p. 712):

> The association itself did not take part in the instruction of students of the university. It employed no teachers and offered no courses of study. The mere business of selling books or other "general merchandise" on a college campus does not connote an "educational purpose." The university itself was the sole institution which engaged in the instruction and education of its students and it alone would be entitled to the exemption permitted by the statute.

The distinction made by the trial court (R. 80-81) in its oral opinion between the instant case and the *Stanford* case is not convincing. It is true that the earnings and profits of the Stanford book store did inure to the benefits of private individuals. But neither that book store nor the one involved herein met the first requirement of the statute, i.e., that it be organized and operated for educational purposes.[8]

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[8] The other book store case involved Montana State University. *Assoc. Students' Store v. Commissioner*, decided March 5, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42, 132). There, a corporation, operating a book store and lunch room in connection with the University, contended that it was so closely integrated and coordinated with the school that it should be tax exempt. In rejecting this argument, the Board stated:

> Such control as the University exercised over petitioner was supervisory in character. Such supervision was permissive rather than based on

The decision in *Roche's Beach, Inc. v. Commissioner*, 96 F. (2d) 776 (C. A. 2d),[9] stems from a

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any legal rights. *Situated on the campus and depending, as it did, on the students and faculty of the University for its business success, the bookstore had to operate in a manner approved by the University authorities.* Petitioner asserts that the control of the State and the University over its funds and affairs is demonstrated by the pledging of its investment income by the State Board of Education. This assumption of authority was never contested by the petitioner, possibly because it was to petitioner's own advantage to secure the new quarters in the Student Union Building. (Emphasis supplied.)

The Board came to this conclusion despite the fact that the articles of incorporation specified the object of the corporation to be the fostering of the educational interests of the students (as contrasted with the commercial motives expressed in taxpayer's articles of incorporation), that the manager of the book store was appointed by the board of directors and the president of the University and the student auditor exercised general supervisory powers over its financial affairs and accounts. See also I. T. 2636, XI-2 Cum. Bull. 102 (1932); G. C. M. 159, V-2 Cum. Bull. 67 (1926).

[9] The *Roche's Beach* case involved subparagraphs (6) and (14) of Section 103 of the Revenue Act of 1928, c. 852, 45 Stat. 791, the relevant portions of which are identical with subparagraphs (6) and (14) of Code Section 101. The Tax Court there denied the exemption on the narrow ground that the purposes for which a corporation is organized and operated must be found exclusively in its charter. The Court of Appeals rejected this view and proceeded (p. 778) to discuss a question which "has not been argued by the parties."

misconception of the Supreme Court's holding in *Trinidad v. Sagrada Orden*, 263 U. S. 578. In the *Sagrada Orden* case, a religious organization that was otherwise tax exempt undertook as a minor part of its activities to sell wine and chocolate to its member churches, from which activities it received a trivial amount of income. The Government took the position that these activities deprived the organization of its tax exempt status, because it was not "operated exclusively" for religious purposes. In holding that the organization did not lose its exemption, the Supreme Court in its opinion (p. 581) used language suggesting that the exemption depended not upon the "source of the income", but rather upon its "destination." However, the Court noted (p. 581) that such limited trading, if it can be called such, is purely incidental to the pursuit of those [religious] purposes, and is in no sense a distinct or external venture. The crux of its opinion is to be found in the following language (p. 582):

> As respects the transactions in wine, chocolate and other articles, we think they *do not amount to engaging in trade in any proper sense of the term. It is not claimed that there is any selling to the public or in competition with others.* The articles are merely bought and supplied for use within the plaintiff's own organization and agencies — some of them for strictly religious use, and the others for uses which are purely in-

> cidental to the work which the plaintiff is carrying on. That the transactions yield some profit is in the circumstances a negligible factor. *Financial gain is not the end to which they are directed.* (Emphasis supplied.)

The plain implication of the Supreme Court's decision in the *Sagrada Orden case* (and its later decision in the *Better Business Bureau* case, *supra)* is that a corporation "selling to the public or in competition with others" for "financial gain" is not within the exempt class, even though it also performs tax exempt activities. In harmony with the principles enunciated in that case, the Treasury Regulations have since 1924 provided that an organization which has exempt purposes "and which also manufactures and sells articles to the public for profit, is not exempt." Art. 517 of Treasury Regulations 65 under the Revenue Act of 1924; Sec. 29.101(6)-1 of Treasury Regulations 111 under the Code. Since a corporation which engages in *both* tax exempt and profit-seeking commercial activities is not entitled to exemption, clearly one which carries on *only* commercial activities for profit is not. If the A.S.S.C.W. stockholder here carried on taxpayer's book store and restaurant business in addition to its educational activities, under the reasoning in the *Sagrada Orden* case it would be subject to tax on its business income. Taxpayer, which carries on no educational activities

whatever but which is only a mercantile establishment, stands in no better position. In short the very reasons which impelled the Supreme Court in the *Sagrada Orden* case to hold that the religious organization there involved was exempt compels the opposite conclusion in this kind of a case.

Nevertheless, in view of the language in the *Sagrada Orden* opinion that the "destination" rather than the "source" of the income is the test, a widespread practice has arisen in recent years whereby ordinary business corporations have sought exemption, not because their activities were charitable or educational but because of the "destination" of the income, their stock being owned by a charitable or educational institution. The majority opinion in the *Roche's Beach* case lent impetus to this practice by construing the *Sagrada Orden* decision as holding that the "destination" of a corporation's income is the exclusive test of its right to exemption. But, as Judge Learned Hand observed in his dissenting opinion in that case (p. 779), the *Sagrada Orden* case "gives no color to such an interpretation; rather the reverse."

Thus, for the cogent reasons pointed out in this dissenting opinion in the *Roche's Beach* case, that case was incorrectly decided and should not be fol-

lowed by this Court. That Congress had not endorsed the interpretation placed upon Section 101 (6) and (14) in the *Roche's Beach* case is apparent from Sections 301 (b) and 302 of the Revenue Bill of 1950 (H. R. 8920, 81st Cong. 2d Sess.) and the committee reports accompanying that bill.

Neither has the Treasury Department subscribed to the interpretation placed upon the statute in the *Roche's Beach* case. Since 1924 the Treasury Regulations have provided that to qualify for exemption a corporation must be "organized and operated exclusively for one or more of the specified purposes", and that one "which also manufactures and sells articles to the public for profit, is not exempt." Art. 517 of Treasury Regulations 65 under the Revenue Act of 1924; Sec. 29.101(6)-1 of Treasury Regulations 111 under the Code. The Regulations cannot be said to be plainly inconsistent with the statute, and hence they must be "deemed to possess implied legislative approval and to have the effect of law" by virtue of reenactments of the statute. *Commissioner v. Flowers*, 326 U. S. 465, 469; *Boehm v. Commissioner*, 326 U. S. 287, rehearing denied, 326 U. S. 811; *Helvering v. Winmill*, 305 U. S. 79. Since the Regulations preclude exemption of corporations which carry on both exempt and business activities, they

manifestly also preclude exemption of those which carry on only business activities.

Admittedly, the decision in *Roche's Beach*, although contrary to the statute and the Regulations, was at first accepted by the General Counsel of the Bureau of Internal Revenue as a precedent in other cases involving substantially the same facts. G. C. M. 20853, 1938-2 Cum. Bull. 166; G. C. M. 21610, 1939-2 Cum. Bull. 103; G. C. M. 22116, 1940-2 Cum. Bull. 100. But these rulings were later revoked, and since 1942 the Commissioner has expressly refused to follow the *Roche's Beach* decision. G. C. M. 23063, 1942-1 Cum. Bull. 103. Certainly the Commissioner was not obliged to perpetuate rulings of his General Counsel which were inconsistent with both the statute and Regulations. The doctrine of legislative approval of the Treasury's interpretation by reenactment of the statute does not apply to departmental rulings which (unlike Treasury Regulations) are not promulgated by the Secretary. *Biddle v. Commissioner*, 302 U. S. 573, 582; *Helvering v. N. Y. Trust Co.*, 292 U. S. 455; *Higgins v. Commissioner*, 312 U. S. 212, 215-216.

Even if the Commissioner had not revoked his acquiescence in the *Roche's Beach* decision back in 1942 (G. C. M. 23063, *supra)*, but were attempting

to do so now for the first time, that would not operate as a bar to a correct construction of the statute either by the Commissioner or this Court. *Smyth v. California State Automobile Ass'n*, 175 F. (2d) 752 (C. A. 9th), certiorari denied, 338 U. S. 905; *Keystone Automobile Club v. Commissioner*, 181 F. (2d) 402 (C. A. 3d).

6. Nothing in the legislative history of Section 101 (6) and (14) supports the conclusion reached by the trial court. The provisions now contained in Code Section 101 (6), in so far as here relevant, first appeared in Section II G(a) of the Income Tax Act of 1913, c. 16, 38 Stat. 114; while those contained in Code Section 101 (14) first appeared in Section 11 (a) Twelfth, Revenue Act of 1916, c. 463, 39 Stat. 756. The committee reports which accompanied those Acts shed no light one way or another on the question here presented.

The first attempt by Congress to clarify the provisions of Section 101 (6) and (14) is to be found in the Revenue Bill of 1950, H. R. 8920, 81st Cong., 2d Sess. It is abundantly clear from the background and provisions of that Bill, as well as the accompanying committee reports, that Congress never intended to sanction the tax exemption of business corporations, like the one in the instant case, merely because

their earnings are destined to tax exempt organizations.

In view of the above we submit that the District Court was in error in holding that the taxpayer is a corporation organized and operated exclusively for educational purposes. It carried on an ordinary mercantile business and therefore should not be immune from federal income taxation.

CONCLUSION

It is respectfully submitted that the judgment of the District Court should be reversed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this chapter:

* * *

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

* * *

(14) Corporations organized for the exclusive purposes of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this chapter;

* * *

(26 U. S. C. 1946 ed., Sec. 101.)

SEC. 116. EXCLUSIONS FROM GROSS INCOME [As amended by Section 2, Public Salary Tax Act of 1939; Sections 148, 149, 1942 Act; Sections 107(b), 125(a), 1943 Act].

In addition to the items specified in Section

22(b), the following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * *

(d) *Income of States, Municipalities, Etc.* — Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

* * *

(26 U. S. C. 1946 ed., Sec. 116.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.101(6)-1. *Religious, Charitable, Scientific, Literary, and Educational Organizations and Community Chests* — In order to be exempt under Section 101 (6) the organization must meet three tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes;

(2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and

(3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

Corporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor. The fact that a corporation established for the

relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily deprive it of exemption.

An educational organization within the meaning of the Internal Revenue Code is one designed primarily for the improvement or development of the capabilities of the individual, but, under exceptional circumstances, may include an association whose sole purpose is the instruction of the public, or an association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community even though an association of either class has incidental amusement features. An organization formed, or availed of, to disseminate controversial or partisan propaganda is not an educational organization within the meaning of the Code. However, the publication of books or the giving of lectures advocating a cause of a controversial nature shall not of itself be sufficient to deny an organization the exemption, if carrying on propaganda, or otherwise attempting, to influence legislation forms no substantial part of its activities, its principal purpose and substantially all of its activities being clearly of a nonpartisan, noncontroversial, and educational nature.

Since a corporation to be exempt under Section 101 (6) must be organized and operated exclusively for one or more of the specified purposes, an organization which has certain religious purposes and which also manufactures and sells articles to the public for profit, it not exempt under Section 101 (6) even though its property is held in common and its profits do not inure to the benefit of individual members of the organization. See Section 101 (18) as to religious or apostolic associations or corporations.

A corporation otherwise exempt under Section 101 (6) does not lose its status as an exempt corporation by receiving income such as rent, dividends, and interest from investments, provided such income is devoted exclusively to one or more of the purposes specified in that section.